COMMODITY FUTURES TRADING COMMISSION'S PILOT PROGRAM IN OPTIONS TRADING FOR NONAGRICULTURAL COMMODITIES

HEARING

BEFORE THE

SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION

OF THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

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WEDNESDAY, OCTOBER 14, 1981

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 324, Russell Senate Office Building, Hon. Richard Lugar (chairman of the subcommittee) presiding.

Present: Senators Lugar, Helms, and Huddleston.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. The subcommittee will come to order.

The Subcommittee on Agricultural Research and General Legislation has assembled here this morning to receive a briefing from Philip Johnson, Chairman of the Commodity Futures Trading Commission, on a CFTC proposal for a 3-year pilot program for domestic exchange traded commodity options and CFTC actions to establish a national self-regulatory organization known as the National Futures Association. Section 4c(c) of the Commodity Exchange Act requires that the CFTC submit "documentation of its ability to regulate" commodity option transactions sucessfully, and as well as a copy of its proposed rules for such regulation before such a program in options trading is launched. This subcommittee's review of the establishment of the National Futures Association is being undertaken as part of the full committee's general oversight responsibilities.

We are pleased to have Mr. Johnson here with us this morning. After Mr. Johnson has finished his remarks, the floor will be open for questions from the subcommittee members. I will simply add in addition to this formal statement which will commence the hearing that indeed it is a great pleasure to have you here this morning, Mr. Chairman, I am one of the admirers of the work which you have been doing which has been noble and pushing along the agenda in an area of American commerce that is very important to the market system. Those of us who have championed the cause of the CFTC have seen real merit in its contribution are delighted that you have brought this leadership and are eager, really, to hear your point of view this morning on how you've been doing, what sort of problems that you have been facing as well as the very

specific areas of oversight which I have mentioned, namely, the 3-year pilot program and now, of course, the National Futures Association ideas. So, at this point, I would be very pleased if you would proceed with your testimony.

STATEMENT OF HON. PHILIP McBRIDE JOHNSON, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. JOHNSON Thank you very much, Mr. Chairman. I have with me today several members of the staff of the Commission who are conversant with the principal subjects that we will be covering this morning. I would like to introduce them at this time. On my immediate right is John Manley, Director, Division of Trading and Markets. Next to him is James Culver, Director, Division of Economics and Education. Next to him is Paula Tosini, Director, Research Unit, Division of Economics and Education, and at the far end is Thomas Loughran, Director, Division of Enforcement.

Mr. Chairman, there are a variety of documents which we have provided the committee which I would like to ask to have entered into the record.

SENATOR LUGAR. Without objection, so ordered.[1]

Mr. JOHNSON. Thank you very much.

Mr. Chairman and members of the subcommittee, the past several months have been busy ones for the Commission. Thirteen new futures contracts have been approved since July, as contrasted with two approvals in the earlier months of 1981. The Commission has announced the elimination of a redundant reporting requirement, reducing paperwork for the industry by roughly 375,000 documents a year. The Commission assessed the largest civil penalty in its history—$500,000. A campaign has been initiated to enlist State law enforcement agencies in the prosecution of confidence games masquerading as commodity investment programs. And, of course, the Commission took two historic steps: the development of a pilot program for the trading of options on futures contracts on the designated contract markets; and approval of the National Futures Association as the first registrant under section 17 of the Commodity Exchange Act.

While these remarks will focus on the pilot program and the NFA, I must report to the subcommittee that the Commission's high level of activity in recent months is directly attributable to the dedication and long hours contributed by our most able staff, and to the cooperation and support that I have received from each of my fellow Commissioners.

I'll begin by discussing exchange-traded options.

On September 8 of this year, after nearly 6 years of study and debate spanning the administrations of all three of the Commission's Chairmen, the Commodity Futures Trading Commission adopted a comprehensive set of regulations under which licensed commodity exchanges in the United States may initiate trading in options on certain commodity futures contracts. The final regulations are underpinned by the thousands of pages of study, dialog, and public comment generated on this subject since 1975.

This is both the best time, and the worst time, to undertake this new venture. It is the best time because every conceivable issue has

[1] See pp. 23-28 for the documents submitted by Mr. Johnson.

been fully and exhaustively examined; because economic uncertainty today cries for every price-risk management tool that ingenuity can devise; and because the Nation's contract markets have strengthened their self-regulatory systems to the point where greater reliance on them is possible than at any previous time in their history. It is the worst time because the Commission, like all of Government, faces severe resource constraints despite rapidly expanding responsibilities.

Budgetary constraints require us to address questions that seemed secondary in flusher times. To what extent can we meet future growth with programs already in place, without designing new and costly systems? Can the private sector be called upon to carry its fair share of the burden? And can we defer adopting new demands, especially in the regulatory arena, until we know that they are really needed?

The Commission's decision to establish a pilot program for exchange-traded options came only after each of these questions had been raised and answered. First, it was determined that an entirely new regulatory program was not necessary. Most of the fundamental features of the pilot program—licensing, financial requirements, segregation of customer funds, trading standards, and so forth could be readily folded into existing programs governing futures trading. There was no need for dozens of new regulations, and scores of new personnel, to monitor activity similar if not identical to what is already being done in futures. Second, the existing exchanges could and should be called upon to play a greater role in assuring public protection. The pilot program achieves this in a variety of ways, with the Commission in an alert oversight role. And, third, the temptation to test new regulatory concepts within the pilot program, and the tendency to impose new restrictions where no need for them has yet been shown, were resisted by the Commission. Recognizing, of course, that they can and will be put into place if necessary in the future. These decisions, I should point out, were made before the President concluded that additional budget cuts may be needed. In this new environment, our decisions to streamline the pilot program take on even greater importance.

And so, the Commission has decided to proceed with a pilot program for a 3-year period. Options will not be permitted on the farm products listed in the Commodity Exchange Act, but a licensed contract market may apply to the Commission to trade an option in any of the other commodity futures contracts, such as metals, energy products or financial instruments. Only one option per exchange will be allowed, and that option must be on an active futures contract sponsored by the same market.

Virtually all of the existing futures requirements will apply to options trading. In short, options will be blanketed in the accumulated protections of 60 years of futures regulation.

But the pilot program does not stop there. A number of new and additional requirements have been imposed by the pilot program. Some of these added duties are in recognition of the fact that options trading may attract persons less affluent and less sophisticated than the typical futures trader. Other new requirements

implement a step mentioned earlier, namely, demanding more public protection by the sponsoring exchanges themselves.

Under the pilot program, option customers will not be permitted to begin trading until they have received the most detailed disclosure statement that the Commission has ever required and, even then, trading cannot be started until the customer has acknowledged in writing that the disclosure statement was both received and understood. This requirement is designed to counter high-pressure selling tactics that rush the uninformed into the market, usually to their sorrow.

The disclosure statement, however, is not all that the FCM must provide to an options prospect. There must also be whatever additional disclosure, information or explanation is needed by the particular customer to fully understand the risks of options trading. The nature of this additional explanation is governed by the customer's personal circumstances, and the FCM must exercise prudent judgment in determining those personal circumstances and in tailoring the added explanation accordingly.

The FCM must have written sales practice procedures, as well as adequate supervision, to assure that its duty to customers is fully met. High-pressure sales techniques common to boiler room operators, such as deceptive "cold call" solicitations, are not permitted. And the sponsoring exchange must police the FCM's compliance through effective audits and investigations of sales practices, backstopped by the Commission itself.

Special restrictions are imposed on discretionary options accounts, that is, where the customer allows the FCM to make trading decisions. The customer must be advised of the trading strategies that the FCM will use. Moreover, these accounts must be specially approved and intensively supervised by FCM officials, on a trade-by-trade basis. This will inhibit churning of accounts and reckless practices by over-eager salesmen.

All of the FCM's promotional material must be scrutinized by the exchange for accuracy, and the FCM must be prepared to document its promotional claims. This check on flim-flam advertising and sales pitches should discourage what was once the very core of options fraud.

Another novel requirement of the options program is that an FCM may not sell a particular option unless it belongs to the sponsoring exchange, or unless it belongs to a registered futures association that regulates the options activities of its members. In other words, no FCM can sell an option unless it is subject to policing by a self-regulatory organization as well as by the Commission. In this fashion, options customers are assured of protection at two levels.

In addition, the exchanges will be required to monitor the activities of large options traders through the collection and review of reports from those traders. The exchanges will also be called upon to conduct studies of options trading, and to make monthly reports to the Commission on commercial activity in the market.

History has taught many useful lessons about options, especially how not to trade them. The so-called privileges in grain that existed during the early part of the century, and that were outlawed in 1936, remain prohibited. So do the options on London futures con-

tracts that victimized the public in the 1970's. The pilot program endeavors, for really the first time in history, to create an effective regulatory environment in which modern options can be truly tested as risk-management tools.

Commodity options have the potential to help businessmen manage their price risks and, in some instances, options can be a more appropriate vehicle than futures for this purpose. Recall, if you will, that futures contracts obligate their owners to two equal and opposite effects. If prices move favorably, the owner receives all of the profit. But if prices go the other way, the owner will suffer all of the losses. For example, in the early 1970's soybean prices rose from the $3 range to nearly $13 a bushel. Many soybean merchants, however, were already holding short futures contracts against the risk that prices would fall. As prices marched upward, these merchants incurred losses of over $9 per bushel on their futures positions, which they had to pay. To be sure, the merchant's inventory of soybeans had appreciated in value at the same time, but the losses on the futures contract wiped out most or all of that unexpected profit.

Now, options on soybeans are not allowed under the Commodity Exchange Act. But if an option had been available, the soybean merchant could have fared better. The merchant could have acquired "put" options, which protect against price declines. The cost of those options would have consisted of a one-time fee or "premium." Had prices fallen, the option would have protected the merchant against the loss. But prices increased fourfold. The soybean merchant would simply have let the option expire, which is permitted in options trading. His loss would have been simply the premium already paid, probably far less than the loss on a short futures position. And, except for the premium cost, the merchant would have realized the profit from the substantially higher value of his soybean inventory.

Options can also be used more economically than futures when the size of a price risk is unclear. For instance, a photographic film producer needs silver, but the amount of silver will depend upon the demand for film. That demand may be very hard to predict. The producer runs the risk of overestimating its silver needs. Nevertheless, some protection against an increase in silver prices should be acquired. The producer can buy "long" futures contracts, or it can buy "call" options that protect against price increases. If more futures contracts are bought than are really needed, the producer actually becomes a speculator in the excess contracts, and is at serious risk. But, using options instead, the only risk run is that some extra premiums will be paid. The producer can readily calculate the extent of that risk, whereas the risk of futures positions can fluctuate widely with changes in market prices.

The potential uses of options as price-risk management tools go far beyond these examples. We have filed with the subcommittee a more extensive discussion of the subject, using a variety of commodities and a number of different users. Only time will tell whether commercial interest occurs. Through studies and the monthly collection of reports on commercial usage of options, the Commission will be able to monitor whether options are serving their intended economic purpose.

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The pilot program is a blueprint for exchange-traded commodity options. It provides a cautious regulatory environment for options on futures contracts and can serve as the basic foundation for options on physical commodities as well. While the Commission believes that the pilot program is adequate for this purpose, adjustments can and will be made to close any gaps or to resolve any problems that may emerge during the program's operation.

Mr. Chairman, I would like to now address the National Futures Association.

In late August of 1976, I received a telephone call summoning me to a meeting of officials from two commodity exchanges. When I arrived, they expressed their interest in forming a nationwide organization that would police areas of the commodity industry that the exchanges could not reach. They asked me to serve as their counsel, and I agreed. The National Futures Association was conceived that hot afternoon, and I was there. Five long years later, after innumerable meetings, drafts and debates, the NFA was delivered into this world when the Commission, on September 22 of this year, granted it official registration. For that event I was absent, recused from participation in the Commission's decision by the very events that I have described. I felt like an errant father, there at conception but gone at birth. Even so, the child was born healthy and hearty and, to me, that was all that counted.

The NFA is the product of several historical developments. One event was the options scandals of the early 1970's which, although no part of the legitimate commodity community, demonstrated that the industry's image could be seriously damaged by fraudulent practices that the industry was then helpless to prevent. Another event was the elimination of fixed commission rates on the exchanges, a tool used for decades to induce firms to join the exchanges by offering them lower commissions than were paid by nonmembers. This commission structure was replaced by rate bargaining, which made it possible for many firms to negotiate low rates without joining the exchanges. As a result, the exchanges lost control over both the ethics and solvency of those firms. A third event was the proliferation of rules on different exchanges governing the same activity that were sometimes conflicting and often confusing, even to the compliance officers of the most conscientious firms. What was permitted on one exchange might be prohibited on another. The firms longed for more uniform rules, especially in the customer-relations area. And, finally, in 1974, Congress made the wise decision to provide in the Commodity Exchange Act for the creation of registered futures associations, and thus for the opportunity to tackle the problems that I have enumerated.

The NFA is structured to address many of these issues. I regret to say that the real bandit operations, determined to prey on the public, will continue to be elusive. They will still try to hide in the darkest crevices of society, ignoring or defying all regulatory efforts, both public and private. For them, swift injunctions and even criminal prosecution are the only effective answers. But the NFA, as a highly visible pool of legitimate commodity firms, should make it much easier for the public to select an honest firm.

The NFA will also govern the many firms that today, for economic reasons or otherwise, do not join the exchanges and are

therefore exempt from exchange oversight. These include a number of futures commission merchants and their salesmen, commodity pool operators, and commodity trading advisers managing customer accounts. In round numbers, the NFA will bring self-regulation for the first time to 135 FCM's, 1,100 commodity pool operators, and 1,300 commodity trading advisers.

The NFA will establish sound ethical standards against fraud, manipulative practices, bucketing, and other abuses. It will also impose rigorous financial requirements. Uniform customer-relations rules will exist which, in time, could replace the maze of differing duties now imposed by the various exchanges. An arbitration system will be available to resolve disputes. The NFA will also be empowered to police aspects of options trading under the Commission's newly approved pilot program.

Any individual or entity associated with the commodities industry is free to join the NFA. However, the NFA plan envisions certain economic consequences of not joining that would effectively compel membership for futures commission merchants, commodity pool operators, and any commodity trading adviser that places orders for clients. You will recall that in 1978, Congress authorized the Commission to approve a compulsory membership plan. Simply put, NFA members would not be allowed to accept or to execute orders received from an FCM, CPO, or CTA that has not joined the NFA—or another registered futures association. Assuming that FCM's belonging to the contract markets join the NFA, they would refuse to handle the business coming from non-NFA firms.

Three categories of primary members of the NFA are: first, contract markets, second, FCM's; and third, CPO's, order-handling CTA's, commercial hedgers, banks, and others associated with the commodity industry. Each of the categories will have representation on the NFA's 40-person board of directors. The composition of the board takes into account both the size and the location of members. An executive committee of board members will oversee the NFA's day-to-day operations, and the NFA's president and other officers will provide the management skills.

A full-scale disciplinary system will exist. A procedure will also exist to deal with financial problems that a member FCM may encounter. And, as I mentioned earlier, an arbitration program will be in place.

The Commission sought and received comment on the NFA plan from several Government sources including the SEC and the Justice Department, and also from the National Association of Security Dealers. The NASD and the SEC spoke highly favorably about the project, but there were certain comments received from a unit within the Justice Department that were critical of the program. The Department, for instance, questioned the compulsory membership feature of the plan, both its propriety and its necessity. The Commission welcomed those views, considered them carefully, and concluded that compulsory membership is necessary if the NFA is to be a truly effective policeman for the industry.

In the Commission's view, the NFA is a major step toward enlisting private initiative in the ongoing effort to assure honesty and integrity in the commodities industry. It is an excellent "fit" with the preexisting self-regulatory programs administered by the con-

tract markets, filling gaps without duplicating exchange-sponsored activities. It also enables the Commission to look more to the private sector for assistance, and to allocate our resources more efficiently. Quite unintentionally, the timing of the NFA's creation has dovetailed nicely with the current budgetary climate and with the Commission's growing need to keep up, step for step, with this prolific and ingenious industry. We welcome the NFA and pledge to work with it to realize its full promise and potential.

Thank you, Mr. Chairman.

Senator LUGAR. We have been joined earlier in your testimony by the distinguished Senator from Kentucky, Senator Huddleston, the ranking minority member of the committee and one who has had historic interest in the CFTC legislation. We are grateful for his presence this morning. Let me just make a point before asking a question. There has been some question, I'm advised, as to when the 30-day congressional review period expires and the staff of the House committee and the Senate committee have come to the conclusion, which I hope you share, that October 25 is the magic date when the 30-day limit expires. I make that point because this subcommittee meeting, in my judgment, is timely. The staff has done well to prepare us for this so that if there are comments of subcommittee members, members of the full committee, or members of the Senate as a whole, they can be made on the basis of the record that is established here today and the informed comments that you have made and questions and answers.

Let me ask at the outset, if the fiscal year 1982 budget for the CFTC is reduced by 12 percent, and I use that percentage because it is sometimes batted about as the amount that might be used across the board for various agencies. It is my understanding that that would be $2.15 million in the case of the CFTC and what would that do in terms of your ability to undertake and supervise the pilot options trading program which you have discussed, the National Futures Association self-regulatory program which you have discussed, or other programs undertaken by the CFTC?

Mr. JOHNSON. In the case of the pilot program for options and the NFA, our assessment is that the impact on those two programs would not be great. The timing of these projects is such that the full impact of their creation probably would not be felt until fiscal 1983. I may be deferring the harder answer to your question for 1 year, but, in any event, we anticipate that the options pilot program, if put into effect, will result in receipt of proposals from the exchanges prior to the end of this year, review by our staff during the first quarter or into the spring of 1982, become operational sometime during the summer of 1982, and that significant trading volume should not be realized until the beginning of fiscal 1983. So, what we are confronting as an agency in connection with options is fundamentally a processing function during fiscal 1982 which is something which we have been able to calculate as manageable. In the case of the NFA, it is my understanding that they are going to do their best to be organized in the sense of having some staff and some place to hang their hat within 6 months and they will spend the next 6 months after that processing applications from the Future's Commission merchants for membership and beginning to get their staff and their programs organized. So, once again, I

think fiscal 1983 is the period during which NFA will be fully operational and, if it is as promising as we hope it to be, I think our oversight will not be very intensive after that. If it would have to be that intensive. So on those two I do not—I am not pessimistic.

As for other things, such as our recent ability to speed up contract market designations and something that I cannot applaud the staff and the Commission too strongly for, that troubles me—that takes some time—we have developed a quicker pace at the Commission and I would hate to see that sacrificed by restrictions on staffing and restrictions on resources, but if there is a way to keep up the pace that we have developed in recent months, in any way, we will certainly pursue that.

Senator LUGAR. Under the proposed options trading program and prior to the effective functioning of the National Futures Association the commodity exchanges will play an increased role in the regulation of the marketplace. For the record, will you describe how the CFTC is working with these commodity exchanges with a view toward making sure that adequate regulatory forces people and programs are in place and ready to work when trading in the instruments initiated and what will the CFTC do if it subsequently determines that the regulatory mechanisms established and managed by the commodity exchanges are inadequately supervised the trading in commodity options?

Mr. JOHNSON. Well, as part of the adoption of the framework for a pilot program there was a great deal of interchange between the Commission and all segments of the industry to determine whether or not it was feasible to impose greater regulatory requirements on the exchanges.

The Commission was satisfied as a result of the comments received and the result of other dialog that it would be possible for the exchanges to gear up and take on the added responsibilities. The way our system is set up at this point is that each exchange will be required to come to us a second time. That is, come to us with a formal proposal to trade of a particular option. One of the matters that we will be examining most closely will be whether they have shown a commitment in terms of staffing and funding and programs to be able to handle the added responsibilities we are imposing. We will be looking at the proposed options, but we will also be looking at their operations and if we are not satisfied that any particular exchange can handle the new responsibilities, the options simply will not be approved. If we make a preliminary determination that the necessary programs and personnel are in place or will be in place and are subsequently disappointed, we have the authority in the program to suspend or terminate that particular option on that particular exchange. So we have some safeguards built into the process both to assure initial capability and to react to any disappointment that we might feel.

Senator LUGAR. Mr. Johnson, I shared with you a letter that the subcommittee received yesterday from Senator D'Amato of New York in which he raised certain objections to proceeding with the commodity options program at this time.[1] Specifically, Senator D'Amato urges delaying the implementations of the program for options on commodity futures until a concurrent program for trad-

[1] See p. 28 for the letter from Senator D'Amato.

ing and options on physicals has been developed. Would you please respond to Senator D'Amato's concerns?

Mr. JOHNSON. One exchange has felt so strongly on this issue that they sued the Commission. That was my first experience as a defendant as a member of the Commission.

Senator LUGAR. What are the circumstances of that suit and why?

Mr. JOHNSON. It is an action in the U.S. District Court for the Southern District of New York by the American Stock Exchange seeking to enjoin the Commission from proceeding with the pilot program until such time as the regulatory structure has been developed to permit options on physical commodities. Prior to our meetings on options I was visited—and my colleagues were visited—by representatives of the American Stock Exchange who indicated their strong interest in participating, but in doing it through an option on a physical commodity. As a result of that visit and the comments received, we announced at the meeting where the pilot program was approved that we would make every effort to absorb into the program options on physical commodities as quickly as we possibly could and hopefully, so that they would be ready to go at the same time as options on the futures contracts. We're committed to that position and intend to do everything in our power to see that that does occur. There are special issues raised by options on physicals and particularly when the sponsoring exchanges are stock markets rather than commodity exchanges. We have no doubt that the American Stock Exchange is a very fine institution and very capable of meeting their responsibilities that we would impose. The questions that arise in our mind is how to get a regulatory handle on a market that is not currently regulated by us and to become more acquainted with their methods of operation and how their compliance systems, for example, would mesh with the kinds of responsibilities that we are imposing under the program. So there are some fresh issues raised by going into options on physicals and fresh issues raised by having exchanges not presently subject to our act sponsoring instruments that we would be regulating under our act and we are going to do our best to iron out those problems as promptly and as fast as possible. We hope to have it done by the time that this pilot program takes effect.

Senator LUGAR. Just one more followup on that as you talked about ironing out the problems, does this imply procedures of proceeding with the defense against the lawsuit or with negotiations with the SEC or how really are you proceeding to bring about some peace in this area prior to instituting your program?

Mr. JOHNSON. Well, the wheels of justice move rather slowly, Mr. Chairman, and I would suspect that we would probably have a resolution to this issue on the regulatory level before we have to face a showdown in court. We are defending against the suit on the principle that the pilot program which has languished for 6 years should not languish any further, but the lawsuit is being defended, but I guess just reaching back into some of my legal background, that the likelihood of a resolution in court before we have resolved it peaceably is remote.

Senator LUGAR. Senator Huddleston, do you have questions for the witness?

Senator HUDDLESTON. Thank you, Mr. Chairman. First, I want to commend Mr. Johnson and the Commission for making this proposal at this time. As you know, I've been concerned about this area for a good bit of time and the commitee has more or less been on record that we should explore this area and enter into it when we can be satisfied that we have adequate regulation. The one concern I do have, and that has already been expressed by the chairman, is what affect the potential additional budget cuts will have on top of what has already been reduced. Do you feel confident that you can establish the necessary regulatory machinery to make sure it works satisfactorily?

Mr. JOHNSON. Well, our best assessment, Senator, is that the 1982 budget cuts, if they go into effect, and we have had an appeal hearing with OMB on that question last week, if they go into effect, should not severely impact on fiscal year 1982 activities in either of these two areas because they are essentially in an organizational period for both projects. Fiscal 1983 may be a different matter, but I'm reluctant to look that far ahead because I don't know what fiscal 1983 holds for us.

Senator HUDDLESTON. Well, I don't guess any of us do, but, it's not going to hold anything much more liberal than you have now from the standpoint of the amount of money available. What has been the reaction other than the suit that has been filed, in the commodity market to the pilot program itself?

Mr. JOHNSON. The reactions that I have received have all been positive. There has been a great deal of enthusiasm within the industry to try this new program and I know the exchanges, almost without exception, are vigorously gearing up to enter the business.

Senator HUDDLESTON. I believe you've mentioned that you would permit each exchange to develop only one contract?

Mr. JOHNSON. That's correct.

Senator HUDDLESTON. Now, is that to be spread among the different instruments or could they all be essentially on the same one?

Mr. JOHNSON. We've left that up to the exchanges to pick whatever instrument they'd like and I want to emphasize once again that agricultural commodities are not subject to this program, but in metals, construction materials, energy products or financial instruments, exchanges are essentially left to select their own. There may be some exchanges so enamored to the same commodity that they both want to go head-on competitively in options as well.

Senator HUDDLESTON. Well, I just wondered whether or not it might be better to have some kind of assurances that you were going to get a broad selection. You would want to test a broad selection of different instruments rather than having maybe a concentration of maybe one product?

Mr. JOHNSON. It is unlikely, in fact, I think because of the mix of commodities trading on the various exchanges. It's unlikely that we would have a test of less than perhaps four or perhaps five commodities. There may be some overlaps among some of the exchanges, but we may have as many as seven or eight applications possibly one or two more than that.

Senator HUDDLESTON. I think you would want at least five or six or seven different commodities, wouldn't you?

Mr. JOHNSON. I think the more interesting experiment would be to test options against one metal and one soft commodity like cocoa or sugar and perhaps a financial instrument or an energy product. I do not know at this point what the exchange would do in that regard but I think we will have a decent mix.

Senator HUDDLESTON. You indicate that the palette would require that the exchanges give additional disclosures depending on the circumstances of the customer. Now, how are the exchanges to ascertain what peculiar circumstances might apply to certain customers?

Mr. JOHNSON. The duty of disclosure rests with the Futures Commission merchant. That is, the person dealing directly with that customer and, when an account is open on behalf of the customer, it will be the duty of the Futures Commission merchant to know a great deal about the personal circumstances of that customer. And, that information will have to be recorded so it will be monitored through a check of the FCM's records. The diligence of the firm will be monitored both by the exchanges and by the Commission.

Senator HUDDLESTON. Of course that would totally eliminate the idea of just blanket telephone calls throughout the country on boilerroom operations.

Mr. JOHNSON. There are many features of this program to discourage that, not the least of which is that no order can be accepted until the customer has received and signed a very extensive disclosure statement. That's impossible to do by telephone so the customer will have to come into the office or come into physical contact with the firm in some manner before that process can be done.

Senator HUDDLESTON. I am well aware of the NFA proposal and I'm glad to see it developing. Do you have—would the Commission have—any input in the type of sanctions the NFA might impose against its members for violating for what they establish themselves as an ethical practice?

Mr. JOHNSON. The Commission has very pervasive authority over the content of the rules of the NFA, what their ethical standards are, what their disciplinary procedures are and what their sanctions will be, so yes, we will have to approve all of the features of the NFA claim.

Senator HUDDLESTON. Will the NFA then be also enforcing actual regulations that the Commission has established?

Mr. JOHNSON. No, not at this point. There is no concept of the NFA enforcing either the act or the Commission's regulations. The objective in the long run is to have the NFA through private self regulation relieve the Commission of some of the current regulatory burden that it has and to move out of the Government sector into the private sector some of these features.

Senator HUDDLESTON. Not unlike the large number of professional associations that we have throughout the country that do have self-regulatory procedures and do have the ability to discipline their members, so to speak.

Mr. JOHNSON. That's correct.

Senator HUDDLESTON. Do you see any way this could have worked without the compulsory requirement—would there have been some objection?

Mr. JOHNSON. I have rarely met a human being who was willing to subject himself to the possibility of heavy sanctions.

Senator HUDDLESTON. Voluntarily?

Mr. JOHNSON. Voluntarily.

Senator HUDDLESTON. Since you eventually, of course, will be moving presumably into the markets that you don't have jurisdiction over the stock exchange, what do you see ahead in the way of conflict between your agency and the SEC?

Mr. JOHNSON. The pilot program as it has now been officially adopted is strictly on options on futures contracts and I have received no negative reaction from the SEC with respect to options on futures contracts. Options on physicals impose significantly different problems. Chairman John Shad of the SEC and I have been meeting periodically in an effort to head off the kind of confrontation that you have described and those discussions will continue until such time as we conclude that we have either resolved the matter subject to congressional review or that we are unable to do so. But, at the moment, we are doing everything in our power and Chairman Shad has been most cordial and most cooperative as I have tried to be in reaching an accommodation of these issues so that there is not a problem of overlap or confrontation in these areas.

Senator HUDDLESTON. Thank you, Mr. Chairman.

Senator LUGAR. Thank you, Senator Huddleston. Mr. Johnson, should this committee, in your judgment, take a look at some of the bankers who were financing hedge loans for many of the larger firms and as prices crept up from $3 to $12 their generosity waned considerably and there were moments when it appeared as if the banking community might abandon the current ledgers somewhere along the road from $3 to $13. I think that it would be useful for the committee to consider or reexamine a question of the ethics of the ban on options on agricultural commodities. The problems that arose in the 1920's and the 1930's that led to the abolition of that practice were really aimed at a different kind of vehicle and instrument than what we are talking about today. Certainly in the environment not nearly as policed or controlled as this and under the circumstances it seems to me that it would be worthwhile for the committee to reexamine that issue.

Senator HUDDLESTON. May I inject just a question here—display a little of my ignorance. Would it not present a problem in the farm product commodities, because of the fact that an option is not really a sale physically of the product and, as you say, the option may be allowed to expire so that there is really no sale resulting from an option alone. Does that somehow distort what you might be able to estimate as the supply may be of a given product down the road—the supply and demand.

Mr. JOHNSON. I think the futures contracts are a far better vehicle for the projection of future supplies and future prices than options. An option has to be viewed much closer than an insurance policy. You pay your premium and you get your protection and if you need the protection and suffer the loss you can take advantage

of it by exercising your option and if you don't sustain the loss then you simply bought the insurance and let it expire. So it's a little different function.

Senator HUDDLESTON. So there's no sale of the actual product at that point.

Mr. JOHNSON. That is correct. There is not.

Senator HUDDLESTON. And futures, it's going to change hands one way or the other, is it not, down the road?

Mr. JOHNSON. It's either going to change hands or the party is going to have to liquidate its contract and sustain the same economic effect without taking delivery at that point.

Senator HUDDLESTON. But, you could have a large volume of options on a particular product and when it comes time to exercise the option it may not result in any transfer of the product at all.

Mr. JOHNSON. Well, if it's an option on a physical commodity and it's exercised, it will result in a change of ownership.

Senator HUDDLESTON. If it's exercised?

Mr. JOHNSON. That's right.

Senator HUDDLESTON. But not if it's expired.

Mr. JOHNSON. That's right. If it's not then it's simply like letting an insurance policy lapse.

Senator LUGAR. We will probably have Senator Huddleston's query about a diverse number of contracts as well as this ban on agricultural commodities. Just for the sake of the record could you list the types of contracts that are feasible, not a prediction necessarily of the selection the various exchanges will make. But, I think you mentioned cocoa might be a potential option and when you get into metals, what sort of metals are available for this purpose?

Mr. JOHNSON. Gold and silver are fairly available at this point. Palladium trading in the New York markets, I'm not sure that there is sufficient volume to be a likely candidate. Outside of the metals area there are heating oil futures contracts, leaded and unleaded gasoline. In the construction materials area there are lumber and plywood. In the financial instruments area there is a whole spectrum on instruments from 20-year Treasury bonds down to 90-day Treasury bills. All of which are eligible.

Senator LUGAR. What is the difference between an option on gold or silver and an option on wheat or soybeans. In the case of gold and silver, presumably, these are discreet items of bulk that have characteristics of delivery and feed and so forth. Obviously, grains are different consistency, but, why was the philosophy of the legislation, as best as you can describe it, such that an option might be permitted in gold or silver or in some type of metal used for construction, what have you, as opposed to an agricultural commodity?

Mr. JOHNSON. I don't think it had anything to do with intrinsic differences in the nature of the options. I think they were generally perceived as an option is an option. In the case of an option on wheat, it would only work if there were very strict specifications as to grade and quantity and location and things of that nature as well. So the options would be the same in either event. It was an historical experience that resulted in the ban on options on agricultural commodities.

Senator LUGAR. There are people having had a bad experience on agricultural commodities ban those, so that now if the pilot project is to start up again it is going to be in other areas in which the experience has not been so bad, in which people were not burned in the process.

Mr. JOHNSON. That's correct. I should point out, Mr. Chairman, that the options traded which gave problems were quite a different instrument than what we are talking about. They tended to be carried only overnight—only by members of the exchanges—and for reasons or purposes that would not then or now be considered particularly powerful.

Senator LUGAR. So ultimately given the new types of regulations that are being instituted in the pilot project or even refinements that might come from the project it would not be illogical to assume that at some point if the project is a success—that is if the pilot ran for 3 years—that we could get an agricultural commodity there would not be a specific problem that you see aside from this bad and historical past and improper contracts that were drawn at that point.

Mr. JOHNSON. There is no inherent impediment to the use of options on agricultural commodities.

Senator LUGAR. Following up Senator Huddleston's points because I am intrigued by this problem too, you've described the options situation as an insurance policy in which buyers of these options who have a need to narrow the range of their losss or to fix at least the gain that they have might by premium this insurance policy. Those who have attacked options have often taken a different point of view. They have said that trading in futures was a gamble. Some have gone even farther and described it as a Las Vegas experience or something of that variety. Now they've then taken the further step and said to put an option on top of what already was a very substantial gamble is to gamble further on the oscillations that attend of a significant trend—in other words, if the futures markets took whatever news and set it into a geometric progression upward, that the option bill was on top of that and spins out the oscillation even further and therefore, it is a gamble on top of a gamble. To what extent is that criticism valid?

Mr. JOHNSON. Well, if one were to accept the premise that futures trading is a gamble, then I suppose any instrument on it would be considered an aggravation of the situation. But, the futures contracts are recognized for what they are which is essentially price risk management tools. Then the question becomes is an option in one way or another perhaps a superior way to acquire that type of protection and I think the illustrations I gave in my testimony indicate that there are circumstances in which having an option on a futures contract is a more economical and a safer way to gain the price protection than would be the outright ownership of a futures contract itself.

Senator LUGAR. Mr. Johnson, in your prepared remarks you mentioned certain off-exchange bandit operations, the term which you used, which mimick commodity transactions and prey upon the public from beneath the veneer of legitimacy. Can Federal, State, and local law enforcement agencies take over responsibility with the prosecution of what are really criminal acts committed by

these persons and what solutions, short term or long term, can you offer for successfully dealing with these bandit operations?

Mr. JOHNSON. The bandit operations are used in the context of my testimony to mean firms that are no part of the legitimate commodity industry. They will set up shop professing to offer people an opportunity to invest in usually something fairly exotic and then after collecting these customers' money proceed to disappear from the scene or worse.

Senator LUGAR. You can't compel these people to join the National Futures Association?

Mr. JOHNSON. They probably will not be trading in the futures contracts and I can assure that these people even if they were they would not do that. They would wait for a knock on the door from the sheriff and nothing else would disturb them.

Senator LUGAR. They would not be applying in advance, in other words.

Mr. JOHNSON. That is correct. Now, to answer your question more specifically, the Commission in now engaged in a campaign to enlist the support and assistance of State law enforcement agencies in these areas because we have satisfied ourselves as a practical matter that there is only one adequate response to these kinds of operations and that is swift justice rather than an attempt to fold them into some regulatory structure. The attorney generals of all the States have been notified of our interest and the response has been excellent. We have had a number of cooperative lawsuits with States and I think that as of now I believe we have a brandnew one. We have had five and we are working on one in Illinois at this very moment to have the Illinois Securities Administrator enter the case. The Commodity Exchange Act already contains a vehicle to achieve that. Some of the States have had difficulty getting into this area and taking advantage of that because of local laws restricting their ability to go into Federal court or that have otherwise interfered with their ability to cooperate with us in one way or another. I noticed that just recently the State of California adopted a law which did authorize its commissioner of corporations to come into these kinds of lawsuits and I express the gratitude of the Commission to the State of California for that effort. So the vehicle is already there to attack these unethical operations with a joint Federal/State effort. It may well be that during the authorization the Commission may ask this committee to examine the extent to which the Commission might be permitted to share these enforcement responsibilities for the Federal agencies as well as more formally with the State agencies so that we can direct more of our resources into the marketplace where most of the legitimate activity takes place.

Senator LUGAR. Is it possible that you all have the recommendations to this committee for assistance in the reauthorization legislation it would be helpful to the Commission working with the State governments or with the appropriate State agencies in this respect?

Mr. JOHNSON. Yes, we intend to have some proposals along those lines, one of which may relate to our ability to share trading information with the States. We are under rather strict proscriptions in that regard at the moment, and from time to time we have sought to enlist the assistance of a State to join us in a lawsuit

without disclosing what our evidence is and, as a result, they are a bit reluctant to sign their name to a complaint without seeing the evidence. So in ways such as that we hope to be able to give the States a little better information so that we can get greater cooperation from them.

Senator LUGAR. Mr. Johnson, I join Senator Huddleston in his comment that we are eager to see the National Futures Association succeed. To make two comments—first of all, as to what should be the priorities of NFA as it takes a look at the broad gamut of securities enforcement and second, what specific things your Commission and this committee might do that would be supportive in the early stages of NFA getting off the ground so that it is more likely assured of success?

Mr. JOHNSON. Well, the fundamental structure of the NFA as it has been presented to the Commission is quite sound. It has identified those areas in the commodity industry where effective self-regulation does not presently exist and where it would undertake that responsibility. It does plan as a matter of sequential organization to enter the regulatory area with respect to Futures Commission merchants first, to be followed by regulation of commodity pool operators and commodity trading advisers. That strikes me as a sensible approach in that all futures orders eventually converge on the FCM's and as the funnel gets narrower and narrower that seems to me to be the place where probably one should start to look for problems, but it will fan out in the course of the next 18 months to 2 years into most of the professional businesses in this area. The Commission has been working cooperatively with the NFA to help it flush out its structure and will continue to do that. I do not know if the NFA will return to Congress next year with legislative recommendations as to other improvements that might be made in its enabling statutes. I'm not aware of any at this point, but I've been on the sidelines for quite some time and I can't say for certain what the plans are.

Senator LUGAR. For the benefit of the record may I ask you to spell out in laymen's language the distinction between trading in futures contracts and trading in physicals and to the relationship of each in the trading of options?

Mr. JOHNSON. I'm glad, Mr. Chairman, that you said in laymen's language.

Senator LUGAR. Yes.

Mr. JOHNSON. Trading in physicals means the actual purchase and sale and transfer of title in the commodities from the seller to the buyer. It typically takes place immediately and, if it's not immediately, the sale is perceived to have taken place with delivery deferred for the purposes of finding storage space or due to some other commercial contingency such as that. A futures contract is a commitment on the part of the seller at some defined time in the future to deliver to a buyer a specific amount of a defined commodity at a price agreed to through competitive auction market activity. An option is an opportunity but not an obligation on the part of its owner to call for either the sale or the purchase, that is, the right to deliver up to the other party and to receive from the other party a particular amount of a particular commodity at the auction market established price. But, with the

right of the owner of the option to simply allow the time period, which may be 6 months, to expire, at which point his opportunity to receive or deliver the commodity expires.

Senator LUGAR. To repeat once again just for the sake of clarity there are several exchanges in this country that currently have futures contract trading. How many exchanges would there be to have those sorts of contracts?

Mr. JOHNSON. Well, we have 11 exchanges right now that are designated as contract markets in one or more futures.

Senator LUGAR. Eleven.

Mr. JOHNSON. There are 11 now.

Senator LUGAR. So in the pilot project you were talking about, essentially we are looking at 11 exchanges, at 1 futures contract of each of the 11 on which the pilot project of 3 years 1 options trading opportunity might be placed. For example, exchange A might be trading in gold, now, and it might of its own volition, make a selection that an options program in gold would be its choice for its 1 options situation in this 3-year pilot project.

Mr. JOHNSON. That is correct. That is correct. I should point out that there may be one or two exchanges in the country who trade only agricultural commodities and as a result, will not really have an opportunity to participate unless they come to us with a new commodity contract.

Senator LUGAR. How many of the exchanges of the 11 would be precluded from options by that characteristic?

Mr. JOHNSON. I believe—I'm going to stand corrected—I believe there are only two at this point and that would be the Kansas City Board of Trade and the New Orleans Commodities Exchange.

Senator LUGAR. Are dealing just in agricultural and therefore cannot by definition be going into the options.

Mr. JOHNSON. That is correct. The other nine would have at least one futures contract that would be eligible.

Senator LUGAR. Your testimony today has been that this fiscal 1982 situation is one in which a great deal of organization and planning will be taking place, but it is unlikely that a volume of serious trading will be occurring until fiscal year 1983 in the options programs on these exchanges.

Mr. JOHNSON. That is correct.

Senator LUGAR. The committee has been joined by its distinguished chairman, the Senator from North Carolina, Senator Helms, and would like to recognize you, Jesse, for questions you might have for our witness.

The CHAIRMAN. Thank you, Mr. Chairman, we have been trying to work on the farm bill on the House side this morning. I know you will not be entirely surprised to hear that they have problems over there.

Senator LUGAR. Yes. So I am advised. [General laughter.]

The CHAIRMAN. As a matter of fact, they may have problems worse than we have. In any case, Mr. Johnson, we welcome you here. The GAO is reviewing the operation of the CFTC.

Mr. JOHNSON. That is correct.

The CHAIRMAN. Any feedback from what they finally got?

Mr. JOHNSON. Bits and snatches, Mr. Chairman. I have had two meetings with them having to do with the Commission's reparations program and I do not know what the ultimate recommendation on that will be. They are troubled by the heavy backlog of cases in the reparations program which is something that is a serious concern to me as well.

The CHAIRMAN. Anything in particular you would be interested in sharing or would it do to be sharing with us the questions they have asked?

Mr. JOHNSON. Well, they have been quite fascinated with the question of whether the reparations program is a superior vehicle to having simple private arbitration systems and I have had an opportunity to discuss that with them to some extent. The reparations program is considerably more complex structurally, procedurally, than the private arbitration system. We have not, as a Commission, sat down yet and developed our checklist of things that we may suggest during the reauthorization in this area, but I know that there are ways to streamline the reparations operation. I would like making it purely a small claims court which I think is consistent with the original philosophy of the program, or to create an opportunity for customers to elect between reparations and arbitration in some really meaningful way or there may be a variety of other ideas that we will be able to come to the committee with.

The CHAIRMAN. Thank you, Mr. Chairman.

Senator LUGAR. Senator Huddleston, do you have any questions?

Senator HUDDLESTON. Yes, just one question on options contracts. Is it expected that options contracts will be for a standardized duration of 6 months or even longer or less—what do you anticipate there?

Mr. JOHNSON. It will be for a standardized duration because all options contracts necessarily have an expiration date. I think the plan is that the options may have essentially the same life as the underlying futures contract. In all likelihood, they would call for expiration sometime prior to the delivery month, but it will have essentially the same life as the futures contract.

Senator HUDDLESTON. And would it provide the person who buys the option the opportunity to exercise that option at any time during that period or on specified dates?

Mr. JOHNSON. Exercise into the futures market could occur at any time as I understand it. Of course, delivery on the futures contract would be made in the delivery month.

Senator HUDDLESTON. Well, does that make it any more difficult for you to lease a contract and making determinations as to whether or not any individual would move into a demanding position for any particular commodity and attempting to corner the market if he can exercise on different days the option that he may have purchased?

Mr. JOHNSON. Well, we'll necessarily have to monitor the options activity as well as the futures activity in that particular commodity. There's no question about that. We have as of a couple of weeks ago, adopted a regulation requiring the exchanges to compose speculative position limits on all commodities, partly in response to the silver situation that occurred last year and partly

just as a matter of sound regulatory policy. And, so, we will be having position limits on the options positions that someone can hold as well as the futures positions and quite possibly on a combination of the two. So, we will have to monitor that and by not allowing—under normal circumstances—by not allowing an option to be exercised during the delivery month of the futures contract we should avoid a buildup of pressure on the market as the futures contract enters the delivery period. There may be a case in which we will authorize some exercises during delivery periods if the economic fundamentals make it clear that there is no problem here of potential manipulation, but in a variety of ways we intend to monitor the options market as well as the futures market to avoid the kind of congestion that you refer to.

Senator LUGAR. Just out of curiosity, Mr. Johnson, because the silver situation is still on our minds, what kinds of limits have you recommended or have you instituted on the futures program in silver?

Mr. JOHNSON. Well, we haven't come to specific numbers. What we have done is we have directed the exchanges to submit to us within 90 days position limits on all commodities for which there are no present position limits.

Senator LUGAR. What would a position limit be? Could you define that in laymen's language again so that we can understand?

Mr. JOHNSON. A position limit would be the maximum number of futures contracts or options that any person alone or in concert with others could hold at any given time.

Senator LUGAR. The limit of contracts. That's the definition you are headed for.

Mr. JOHNSON. That is correct.

Senator LUGAR. And that would limit then the amount of the silver market that any one individual or group could control at one time.

Mr. JOHNSON. That's correct.

Senator LUGAR. Are there other questions?

Senator HUDDLESTON. Are you thinking about getting into silver? [General laughter.]

Senator LUGAR. Just checking it out to sort of see what the possibilities might be.

Senator HUDDLESTON. I asked what you wanted to sit on the Senate for now.

Senator LUGAR. Less than $10—$9 and something I don't know.

Senator HUDDLESTON. There's a fellow in Kentucky who is pretty big in racehorses and can give you a lot of advice.

Senator LUGAR. Yeah. Well, Let's not bring that into the hearing. [General laughter.] Well, we're deeply indebted to you for a very thoughtful initial statement and for your answers to the questions of Senators today and to your associates who have been of assistance to you in both moral support as well as informational support this morning. I know the subcommittee and the full committee look forward to working closely with you and the members of the Commission as we approach this very important year of the reauthorization legislation and that this hearing has been called for the purposes of looking at the options pilot program and the National Futures Association as topical instances of our oversight

responsibility but also for the broader thought of gaining rapport with you and your associates and we are grateful to you for your testimony today.

Mr. JOHNSON. Well, thank you, Mr. Chairman, and I want to thank the subcommittee and the full committee for the support and interest and from time to time the critical strutiny it provides the CFTC which is very, very vital to us and I am pleased to have the opportunity to appear here for the first time and look forward to future opportunities as well. Thank you so much.

Senator LUGAR. Thank you very much. The hearing is adjourned.

[Whereupon, at 11:30 a.m. the subcommittee adjourned, subject to call of the Chair.]

APPENDIX

[The following material was submitted by Hon. Philip Johnson, Chairman, Commodity Futures Trading Commission.]

Commercial Uses of Commodity Options

As background for discussing the potential commercial uses of commodity options it is instructive to compare briefly the distinguishing characteristics of options and futures in terms of their use in managing the risk of commodity positions.

A futures contract involves an obligation to buy or sell a specified quantity and quality of an underlying asset on or before a particular time in the future at a price agreed upon when the contract is originated. In contrast, an option represents the right, rather than the obligation, to buy or sell a specified quantity and quality of an underlying asset or futures contract on that asset at a given price on or before a stipulated date.

An option which gives its purchaser the right to buy the underlying asset or futures contract is termed a call, while an option which gives its purchaser the right to sell the underlying asset or futures contract is termed a put. The price at which the asset or futures contract underlying an option can be bought or sold is called the strike or exercise price. To acquire an option, the purchaser must pay a one-time fee, called a premium, to the originator of the option who is known as the option grantor or writer.

When options and futures are traded on exchanges the contracts can, and normally are, terminated by offset—the purchase or sale of an equivalent position on the opposite side of the market—rather than by delivery of the underlying commodity or asset. As indicated above, both the purchaser and the seller (i.e., both the long and the short) of a futures contract must terminate the contract at the specified price, even if such action results in loss to one of the other parties. On the other hand, an option purchaser whose contract becomes unprofitable is not obligated to fulfill it. Since the potential loss to an option purchaser is limited to the option's purchase fee or premium, options have been compared to insurance policies.

The call buyer gains from rises in the price of the underlying asset above the strike price while his potential loss from price declines is limited to the option premium. The call grantor gains from receiving the premium and assumes the risk of loss from price rises above the strike price. In contrast, the put buyer gains from declines in the price of the underlying asset below the strike price while his loss from price rises is limited to the put premium. The put grantor gains from receiving the premium and assumes the risk of loss from price declines below the strike price.

Because purchased options are limited-risk instruments they are an appropriate means to manage one type of risk—uncertainty as to the size of the commodity position which is subject to price risk—which futures markets cannot easily handle. For example, a commemorative coin company may offer to sell a gold coin to the public for $500. Gold bullion needed to mint the coin may cost $350 an ounce at the time the offering is first made. The firm faces a significant risk if the price of gold rises to $500 an ounce or above which would make the fixed-price offering of the coins unprofitable for the company. Since the company cannot determine in advance exactly the number of coin orders it will receive, the firm could set a ceiling on the price of gold for its uncertain needs by purchasing a call option. If the firm over-estimates its needs, the cost of price protection is limited to the premium paid for the options. By contrast, if the company over-estimates its needs and uses futures contracts to hedge the price risk of its coin offering, the firm will sustain the full loss of adverse price changes in the futures contracts which hedge the unsold coin production. This loss can be substantially greater than the premium paid for options.

Even when the approximate size of the commodity position which is subject to price risk is known, a purchased option may still function as an insurance policy against unfavorable price movements while allowing the holder of the commodity to retain the potential gains resulting from favorable price movements. The cost of this

protection, the option premium, is known in advance and can be taken into account in the business decision of whether or not to undertake such "price insurance."

In contrast, hedging on a futures market via a short position can be considered preselling the underlying commodity, while hedging via a long position can be considered prepurchasing the underlying asset. As a result, hedging commodity positions in the futures market involves the forfeiture of potential gains from favorable price movements in return for protection against potential losses due to unfavorable price movements. Returning to the example of the commemorative coin company, if a commodity position is hedged by a long futures position and the futures price moves against the hedger, the loss from the futures price change will offset the gain on the fixed-price coin sales. When a commodity position is protected with an option, the loss is limited to the premium which is known at the outset.

Another means of managing the risk of holding a commodity is to generate income on such a position. The owner of a spot commodity position who writes (grants) an option on that position receives the option premium in return. In this case of covered option writing the commodity position is cushioned against capital loss to the extent of the premium received for writing the option. However, any losses on the commodity position greater than the option premium are borne by the option writer, and any gains on the position greater than the premium accrue to the option purchaser, rather than the grantor.

The following examples illustrate potential commercial uses which may evolve for options based on Government National Mortgage Association certificates (GNMAs), sugar and gold:

1. PURCHASE OF A GNMA PUT OPTION BY A MORTGAGE BANKER

A mortgage banker assembling a GNMA pool makes fixed-price loan commitments to builders and is subject to the risk that interest rates may rise during the several months it takes to complete and certify such a pool. Since the price of a fixed-income instrument (such as a GNMA, a Treasury bill, or a Treasury bond) moves in the opposite direction from the instrument's interest rate, interest-rate rises cause a fall in the price of GNMA's and interest-rate declines cause a rise in the price of GNMA's.

The purchase of a GNMA put option would protect the mortgage banker against interest-rate rises which would reduce the value of the GNMA pool over the period until the pool is completed. For example, if a mortgage banker contemplates it will take 3 months to complete a pool which involves making fixed commitments to lend at 15 percent, the banker might purchase a 3-month put option with a strike price equivalent to a 15 percent interest rate for a premium equivalent to a ½ percent rate of interest. If at the end of 3 months market interest rates have fallen to 13 percent, the price of the completed GNMA pool will have risen. Therefore, the mortgage banker would abandon the worthless put and charge its premium against the profit on the GNMA pool.

On the other hand, if at the end of 3 months market interest rates have risen to 17 percent, the price of the completed GNMA pool will have fallen. In such case the mortgage banker would offset the purchased put in the option market and obtain the difference in the price of the underlying GNMA's represented by the rise in interest rates above the strike price of the option (minus the premium paid for the option). Alternately, the mortgage banker could stand ready to deliver the GNMA pool on a short futures position through exercise of the option at its strike price.

2. PURCHASE OF A GNMA CALL OPTION BY AN INSTITUTIONAL INVESTOR

An institutional investor who is the ultimate purchaser of GNMA pools may anticipate an inflow of funds to invest in three months and may consider 15 percent interest rates to be attractive. Rather than risking a decline in interest rates by the time investment funds become available the institution could purchase a 3-month call option on GNMA's with a strike price equivalent to a 15-percent interest rate for a premium equivalent to a ½-percent rate of interest. If at the end of 3 months interest rates have fallen to 13 percent, the rise in the price of GNMA securities will leave a profit on the purchased call equivalent to a 2-percent rate of interest minus the equivalent of a ½-percent rate of interest paid for the call premium. In this case the purchased call option reduces the loss due to the lower interest rate of 13 percent received when the new GNMA pools are purchased. If, however, interest rates have risen in 3 months to 17 percent, then the price of GNMA's would have fallen below the option's strike price and the call would be worthless. However, the cost of the option (the premium) would be more than offset by the higher return the new GNMA pools would yield upon purchase.

3. COVERED PUT WRITING BY A GNMA DEALER

GNMA dealers make a market in GNMA securities and may trade in the forward market for GNMA's as well. One method of managing the risk associated with forward-market trading would be writing put options in conjunction with a forward commitment to sell GNMA's. For example, a GNMA dealer who has made a 3-month forward contract to sell GNMA's at a price equivalent to a 15-percent rate of interest might grant a 3-month put with a strike price equivalent to the 15-percent rate of interest for a premium equivalent to a ½-percent interest rate.

If interest rates rose to 17 percent in 3 months, the GNMA dealer would gain when selling GNMA's on the forward contract at the higher price equivalent to a 15-percent rate of interest. However, offsetting this gain would be the loss associated with the granted put, leaving a net profit equivalent to a ½- percent rate of interest for granting the option. If interest rates fell to 13 percent in 3 months, the price increase in cash GNMA's would result in a loss equivalent to a 2 percent rate of interest of the forward sale. The premium equivalent to ½ percent interest received for granting would partially offset this loss on the forward sale of GNMA certificates.

4. COVERED CALL OPTION WRITING BY A PRIVATE TRUST

A private trust which has cash GNMA's in its portfolio may write 3-month call options against its 15 percent GNMA investments with a strike price equivalent to a 15-percent interest rate for a premium equivalent to a ½- percent rate of interest.

If in 3 months interest rates have fallen to 13 percent, the trust will find it necessary to offset its granted call for the equivalent of a 2-percent rate of interest. as a result, all price gain on the GNMA certificates held by the trust has been exchanged for the ½-percent premium. Alternately, if interest rates had risen to 17 percent over the period, the price decline equivalent to a 2-percent interest rate would be borne by the trust with the premium on the lapsed option providing a partial cushion to that price decline.

5. PURCHASE OF A SUGAR CALL OPTION BY A SUGAR BROKER

Sugar brokers enter into contracts to merchandise sugar in the spot market and at various times in the future. In some cases a sugar broker may be concerned that a supplier may default on all or part of a contract commitment.

For example, a sugar broker may contract forward to buy 100 tons of sugar from a supplier at 10 cents per pound with delivery in 6 months. The broker may anticipate a price rise in the market with a possible shortage resulting in the supplier's being unable to deliver up to 50 tons of the commitment. To forestall the effects of such an occurrence the sugar broker could purchase a 6-month call option on 50 tons of sugar with a strike price of 10 cents per pound for a premium of 1 cent per pound. If after 6 months the price of sugar had risen to 12 cents per pound and the supplier delivered only 50 tons, the broker could exercise the option and take delivery on the futures contract, thereby receiving 50 tons of sugar at a cost of 10 cents per pound plus the option premium of 1 cent per pound. As a result, the average price for the full 100 tons of sugar would be 10½ cents per pound.

Alternately, if after 6 months the price of sugar had not risen and the supplier delivered the entire 100 tons, the dealer would abandon the worthless call option and secure the sugar at the 10 cents per pound forward contract price plus the 1 cent per pound option premium on the 50 tons. Therefore, the sugar dealer, by purchasing the call option, has assured a supply of 100 tons of sugar at an average price of 10½ cents per pound.

6. PURCHASE OF A SUGAR PUT OPTION BY A SUGAR PRODUCER

A sugar producer will generally have some uncertainty regarding the yield of his crop and may wish to protect himself against that uncertainty. This may be done by purchasing puts on an amount of sugar equal to the difference between a high yield crop and the minimum expected yield. For example, if harvest were in 6 months and the break-even production price for the producer were 10 cents per pound, the sugar producer might purchase a 6-month put with a strike price equal to 10 cents per pound for a premium cost of 1 cent per pound.

If the crop yield were poor and prices rose to 12 cents per pound, the producer would let the option lapse, charging the cost of the option against the higher prices received for the entire amount of the smaller-yield crop. In contrast, if a large sugar crop caused a fall in sugar prices to 8 cents per pound, the amount of optioned sugar would yield the net price of 9 cents per pound. (10 cents per pound strike price minus 1 cent per pound premium cost).

7. COVERED CALL OPTION WRITING BY A SUGAR DEALER

A sugar dealer may enter a 6-month forward contract to buy 100 tons of sugar at 10 cents per pound and may sell a 6-month call option with a strike price of 10 cents per pound for a premium of 1 cent per pound.

If the price of sugar rose during the 6 months to 12 cents per pound, the written call would result in a loss of 2 cents per pound, which would offset the gain on the forward contract purchased at 10 cents per pound. In such a case the dealer's net gain would be 1 cent per pound from the call option premium. However, if the price of sugar fell to 8 cents per pound the loss on the forward contract would be 2 cents per pound and the premium on the lapsed option would provide a 1 cent per pound cushion, reducing the sugar dealer's net loss to 1 cent per pound.

8. COVERED PUT OPTION WRITING BY A SUGAR REFINER

A sugar refiner may sell sugar forward at 10 cents per pound for 6 months and may wish to supplement the income from the sale in the case of a price decline and obtain price protection in the case of small price rises. This may be accomplished by writing a put with a strike price of 10 cents per pound for 6 months for a premium of 1 cent per pound. If prices decline to 8 cents per pound in 6 months the refiner may obtain raw sugar at a price permitting a 2 cents per pound gain on the forward sale. However, the written put will result in a loss of 2 cents per pound leading to a net gain of 1 cent per pound equal to the put premium received. If prices rose to 12 cents per pound, the refiner would lose 2 cents per pound delivering at the forward contract price of 10 cents per pound which loss would be partially offset by 1 cent per pound from the put premium received.

9. PURCHASE OF A GOLD CALL OPTION BY A JEWELRY FABRICATOR

If a fabricator wishes to set a maximum price now for gold needed at a future date he can do so by purchasing a gold call for the period desired. For example, if the price of gold is currently $500 per ounce the fabricator may purchase a 2-month call option with a strike price of $500 per ounce for a premium of $20 per ounce. If the price of gold increases to $530 per ounce the offset or exercise of the call will yield a net purchase price of gold of $520 per ounce, which is less than if the fabricator had not purchased the option.

If the price of gold fell to $470 per ounce, after 2 months the option would lapse and the fabricator would buy gold in the spot market for a net price of $490 per ounce including the call premium. The effect of the call purchase is to lessen the range of prices at which the fabricator is likely to procure the gold when needed and place a ceiling on large price increases which might have a substantial effect on fabrication profits.

10. PURCHASE OF A GOLD PUT BY A MINING COMPANY

A mining company may guard against substantial declines in the value of the gold content of its ore during processing by purchasing put options. If the current price of gold were $500 per ounce and a fall of gold price below $475 per ounce would make mining unprofitable, the company might purchase a protective put with a strike price of $500 per ounce for 2 months for a $20 per ounce premium. If the price of gold increased to $530 per ounce in 2 months, the put would expire worthless and the gold could be sold for a net price of $510 per ounce after deducting the cost of the premium.

If, however, gold prices fell to $470 per ounce, the offset or exercise of the profitable put would make the effective net price of the gold $480 per ounce. ($500 per ounce strike price minus the $20 per ounce put premium). As a result of purchasing gold put options, the mine would be assured a selling price above its break-even level, without foregoing profits from large price rises which might occur.

11. COVERED CALL OPTION WRITING BY A GOLD DEALER

A gold dealer has an inventory which yields neither interest nor dividends but which is subject to the risk of price decline during the period it is being held. The dealer may decide to sell covered call options against the inventory and use the premium to offset the cost of carrying the inventory. If the market price of gold were $500 per ounce and the dealer sold a 2-month call with a strike price of $500 per ounce for $20 per ounce, the dealer would be protected against a loss due to a fall in gold prices as low as $480 per ounce. ($500 per ounce—$20 per ounce premium). However, any rise in the price of gold above $520 is captured by the option purchaser.

12. COVERED PUT OPTION WRITING BY A GOLD REFINER

If a refinery makes a forward sale of gold at $500 per ounce to a dealer for delivery in 2 months the refiner may grant a put option for 2 months with a strike price of $500 per ounce and receive a premium of $20 per ounce. If the price of gold rose to $530 per ounce when delivery was due, the refiner would have to deliver gold worth $530 per ounce for $500 per ounce on the forward contract. This $30 loss would be reduced by the $20 premium received on the granted put which expired worthless; the put premium thus protects the refiner against price rises up to $520 per ounce when it has a forward sale commitment at $500 per ounce. In contrast, if the price of gold dropped to $470 per ounce, the dealer would sustain a net loss of $10 per ounce on the written put matched by a gain of $30 per ounce on the forward sale. Thus, the net gain on the refiner's covered option writing is $20 per ounce, the premium received for writing the put.

Commercial Uses of Commodity Options

Commodity options provide a means to manage commercial risks which complements and supplements the hedging opportunities provided by futures markets. In contrast to a futures contract, a commodity option provides the right, but not the obligation, to buy or sell a commodity or a futures contract on that commodity at a specified price, called the strike or exercise price, on or before a given date. An option which gives the purchaser the right to buy the commodity or a futures contract is termed a call, while an option which gives the purchser the right to sell the commodity or a futures contract is termed a put.

While both parties to a futures contract (i.e., both the long and the short) must honor the contract even when such action results in loss to one of the parties, an option purchaser whose contract becomes unprofitable is not obligated to fulfill it. Since the potential loss to an option purchaser is limited to the option's premium, options have been compared to insurance policies.

Because purchased options are limited-risk instruments they are an appropriate means to manage one type of risk-uncertainty as to the size or quantity of the commodity position which is subject to price risk—which futures markets cannot easily handle. Even when the approximate size of the commodity position which is subject to price risk is known, a purchased option may still function as an insurance policy against unfavorable price movements, while allowing the holder of the commodity position to retain the potential gains resulting from favorable price movements. The cost of this protection, the option premium, is known in advance and can be taken into account in the business decision of whether or not to undertake such "price insurance."

In contrast, hedging on a futures market via a short position can be considered preselling the underlying commodity, while hedging via a long position can be considered prepurchasing the underlying asset. As a result, hedging commodity positions in the futures market involves the forfeiture of potential gains from favorable price movements in return for protection against potential losses due to unfavorable price movements. However, no premium is paid to buy or sell a futures contract.

Another means of managing the risk of holding a commodity is to generate income on such a position and thereby cushion any adverse price movements. The option premium provides such a cushion to the holder of a spot commodity position who writes (grants) an option on that position. However, such covered option writing cushions a commodity position against capital loss only to the extent of the premium received for writing the option; any losses on the commmodity position greater than the option premium are borne by the option writer, and any gains on the position greater than the premium accrue to the option purchaser.

A put option on a sugar futures contract illustrates another potential commercial use of a commodity option. Agricultural producers, in general, face uncertainty as to the size of their crops as well as the prices they will receive when their crops are harvested. And, if there are no significant changes in demand, large crop yields are usually accompanied by relatively low prices while poor yields normally go hand in hand with relatively high prices.

A sugar producer could find it advantageous to purchase a sugar put option with a strike price close to the current market price, on a quantity of sugar equal to the difference between a high yield estimate and the minimum expected yield, which option would expire at about harvest time. If the harvest were bountiful and prices were lower, the increased value of the sugar option would compensate for the price decline of the quantity of sugar covered by the purchased put. That is, the value of the put option at its expiration would be the difference between its strike price and

the lower market price of sugar prevailing at harvest time. Alternatively, if the harvest were poor and sugar prices were higher the sugar producer would abandon the option and obtain the higher price of sugar on the market.

The writer or grantor of such a put option could be a member of the public or another commercial enterprise in the sugar industry. A sugar refiner granting a put option against a fixed-price forward commitment to sell sugar to a confectioner provides an example of the latter type of option grantor. The sugar refiner would obtain income from writing the option—the option premium—which payment would cushion small movements in the price of sugar during the term of the option.

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C., October 7, 1981.

Hon. JESSE HELMS,
Chairman, Agriculture Nutrition and Forestry Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The Committee on Agriculture, Nutrition and Forestry now has before it the Commodity Futures Trading Commission regulations to establish a pilot program for trading commodity options on domestic commodity exchanges. These rules have been submitted to the Committee pursuant to Section 4c(c) of the Commodity Exchange Act.

I understand that the CFTC's pilot program would remove the current prohibition on commodity options trading for only one type of option, namely, options on certain commodity futures contracts which are presently traded on a domestic contract market. The CFTC also has under consideration a further proposal to authorize trading in options directly on physical commodities, but has not proposed to take this step at this time.

While I appreciate the CFTC's judgment that it should proceed cautiously in this area, I am very concerned about the proposal before your Committee because it appears to have certain anticompetitive features which may not be necessary to satisfy the CFTC's regulatory concerns.

First, because it is limited to options on existing futures contracts, the program excludes from competition major exchanges which do not now trade commodity futures. Among these are the major stock option exchanges, which have had extensive experience in options trading. The American Stock Exchange, for example, has proposed to establish a new subsidiary to trade options directly on gold and silver bullion, but would not be permitted to do so under the CFTC's pilot program.

Moreover, the present exclusion of such exchanges from competition in the commodity options market may also adversely affect their ability to compete with similar or related products in the future. It is widely believed, as you know, that the first exchange to offer a new type of contract is accorded a tremendous advantage over any exchange subsequently offering the same or a related product. I believe that the marketplace and not the regulatory process should determine which exchange should enjoy the benefits of becoming the primary market for a particular type of contract.

It seems to me that these anticompetitive effects could be eliminated without harm to the CFTC's overall goals, by delaying the implementation of the program for options on commodity futures until a concurrent plan for trading in options on physicals has been developed. I respectfully urge you to give the closest scrutiny to the CFTC's pilot program regulations, to assure that the program would not unduly discriminate against legitimate markets or the development of alternative market contracts.

Thank you for your consideration of this important matter.

Sincerely,

ALFONSE D'AMATO,
United States Senator.

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